UNIT 13 MUTUAL FUNDS

Objectives

The objectives of this unit are:

- to provide you with an overview of the concept and philosophy of mutual funds;
- to introduce and explain the organization of mutual funds in India;
- to make you conversant with the managing of mutual funds;
- to explain the performance measures of mutual funds in India; and
- to highlight how SEBI has made mutual funds investor friendly.

Structure

13.1 Introduction
13.2 Mutual Funds: A Better Option
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13.1 INTRODUCTION

Mutual Fund is an important segment of the financial system. Mutual Fund is a non-fund based special type of institution which acts as an investment conduit. It is essentially a mechanism of pooling together the savings of a large number of investors for collective investments with an avowed objective of attractive yields and appreciation in their value. A Mutual Fund is a Financial Service Organisation that receives money from shareholders, invests it, earns returns on it, attempts to make it grow and agrees to pay the shareholder cash on demand for the current value of his investment. A Mutual fund offers investors a proportionate claim on portfolio of assets that fluctuates in value with the value of the assets that make up the intermediaries portfolio. It is rather difficult to give a comprehensive concept of a mutual fund. What is a mutual fund is better understood by the functions it performs and role it plays. It is a non-depository financial intermediary. Mutual funds are mobiliser of savings, particularly from the small and household sectors, for investments in stock and money markets. Mutual funds mobilise funds by selling their own shares also known as *units*. When an investor owns a unit in mutual funds he owns a proportional share of the securities portfolio held by a mutual fund. In other words, share of a mutual fund actually represents a part share in many securities that

it has purchased. Mutual fund share/unit certificate combines the convenience and satisfaction of owning shares in many industries. Thus, mutual funds are primarily investment intermediaries which pool investors' funds to acquire individual investments and pass on the returns thereof to fund investors.

The idea of mutual fund had its formal origin in Belgium (Societe Generale de Belgiue, 1822) as an investment company to finance investments in national industries associated with high risks. In 1860s this movement started in England. In 1868, the Foreign and Colonial Government Trust was established to spread risks for investors over a large number of securities. In U.S.A., the idea took root in the beginning of the 20th century. Three investment companies were organised: Massachusetts Investors Trust, State Street Investment Corporation and U.S. and Foreign Securities Corporations. In Canada, during 1920s many close ended investment companies were organised. The first mutual fund in Canada to issue its share to general public was the Canadian Investment Fund in 1932. Subsequently hundreds of mutual funds emerged and expanded their wings in many countries in Europe, the Far East and Latin America. In recent years mutual funds in Japan and Far East countries have been showing excellent performance probably as a result of growth and performances of the economies of these countries and their capital market. Countries in Pacific area like Hong Kong, Thailand, Singapore and Korea have also entered this field in a long way. Mauritius and Netherlands are emerging as tax heavens for offshore mutual funds. Thus, mutual fund culture is now global in scope.

13.2 MUTUAL FUNDS : A BETTER OPTION

Mutual funds can survive and thrive only if they can live up to the hopes and trust of their individual members. These hopes and trust echo the peculiarities which support the emergence and growth of such institutions irrespective of the nature of economy where these are to operate. Mutual funds come to the rescue of those people who do not excel at stock market due to certain mistakes committed on their part. Such mistakes can be viz., lack of sound investment strategies, unreasonable expectations of making money, untimely decisions of investing or disinvesting, acting on the advise given by others, putting all their eggs in one basket, i.e., failure to diversify.

Mutual funds are characterised by many advantages that they share with other forms of investments and what they possess uniquely themselves. The primary objectives of an investment proposal would fit into one or combination of the two broad categories i.e. income and Capital gains. How mutual fund is expected to be over and above an individual in achieving these two said, objectives, is what attracts investors to opt for mutual funds. Mutual fund route offers several *important benefits*. Some of these are:

- Making investments is not a full time assignment of investors. So they can hardly have a professional attitude towards their investment. When investor buys mutual fund scheme, an essential benefit that one acquires is *professional management* of the money he puts in the fund.
- A sound investment policy is based on the principle of diversification which is the idea of *not putting all the eggs in one basket.* By investing in many companies the mutual funds can protect themselves from unexpected drop in value of some shares. The small investor cannot achieve wide diversification on his own because of many reasons, mainly funds at his disposal. Mutual funds on the other hand, pool funds of lakhs of investors and thus can participate in a large basket of shares of many different companies, thus *high value diversification*.

- A distinct advantage of a mutual fund over other investments is that there is always a market for its units/shares. Moreover, Securities and Exchange Board of India(SEBI) requires that mutual funds in India have to ensure liquidity. Mutual fund units of some schemes can be sold in the share market as SEBI has made it obligatory for close ended schemes to list themselves on stock exchanges. For open ended scheme investor can always look for *easy liquidity* by approaching the fund for repurchase at Net Asset Value (NAV) of the scheme.
- Risk in investment is as to recovery of the principal amount and return on it. Mutual fund investments on both fronts provide a comfortable situation for investors. The expert supervision, diversification and liquidity of units ensured in mutual funds *minimise the risk*. Investors are no longer expected to come to grief by falling prey to misleading and motivating headline leads and tips, if they invest in mutual funds.
- Besides depending on the expert supervision of funds managers, legislation in a country (like SEBI in India and Securities Exchange Commission (SEC) in USA) also provides for the *safety of investments*. Mutual funds have to broadly follow the laid down provisions for their regulation. These agencies act as watchdogs and attempt wholeheartedly to safeguard investor interests.
- Mutual funds provide investors flexible investment opportunities. Mutual fund family allows investors to *switch over* from one fund to another e.g. investors can switch from income scheme to growth scheme or vice-versa or say from close ended scheme to open ended schemes as the investors opt.
- Many schemes of mutual funds provide *tax shelter*. In India for equity linked schemes of mutual funds, under section 88, tax rebate up to twenty per cent of investment made in specified schemes of mutual funds(up to Rs.10,000) is available. Income from mutual funds dividends is exempted from tax at present. Such provisions vary from country to country and time to time.
- Mutual funds having large investible funds at their disposal avail economies of scale. The brokerage fee or trading commission ‘may be reduced substantially. *Lower operating costs* obviously increases the income available for investors.
- There is always one segment of society which hesitates to put their money in the capital market. Mutual funds prove to be an effective mechanism in the hands of planners of the economy to convince such segment to put their money to market. Mutual funds prove to be an *effective mode of fund mobilization,* since it relieves them of emotional stress involved in trading of securities.

Investing in securities through mutual funds has many advantages over organising a personnel portfolio. Other advantages include the option to reinvest dividends, strong possibility of capital appreciation, regular returns, etc.. Mutual funds are also relevant in national interest. The test of their economic efficiency as financial intermediary lies in the extent to which they are able to mobilise additional savings and channelising these savings to more productive sector of the economy.

13.3 SCHEMES OF MUTUAL FUNDS

Schemes of mutual funds refer to the products they offer to investors. Investors are to choose out of such schemes as per their objectives of earnings. Mutual funds adopt different strategies to achieve these objectives and accordingly offer different schemes of investments as per the need of investors. Schemes can be grouped as under:

13.3.1 Operational Classification

Open Ended Schemes: Such schemes accept funds from investors by offering its units on a continuing basis. Such fund even stands ready to buy back its securities at any time. It implies that the capitalisation of the fund is constantly changing as investors sell or buy their shares or units (shares in USA, unit in India). Further, these shares or units are normally not traded on the stock exchange. Open ended schemes have comparatively better liquidity despite the fact that these are not listed. The reason is that investor can any time approach mutual fund for sale of such units. No intermediaries are required. Moreover, the realisable amount is certain since repurchase is at a price based on declared net asset value. No minute to minute fluctuations in rates haunt the investors. In such funds, option to reinvest its dividend is also available.

Close Ended Schemes: Such schemes have a definite period after which their units are redeemed. Unlike open-ended funds, these funds have fixed capitalisation, i.e. their corpus normally does not change throughout their tenure. While open ended funds are repurchased or sold directly by mutual funds on the basis of NAV, the close ended fund units being quoted on the stock exchanges are traded amongst the investors in the secondary market. Their price is determined on the basis of demand and supply in the market. Their liquidity depends on the efficiency and understanding of the engaged broker. Their price is free to deviate from the NAV, i.e., there is every possibility that market price may be above or below its NAV.

From management point of view, managing close ended scheme is comparatively easy since fund managers can evolve and adopt long term investment strategies depending on the life of the scheme. Need for liquidity arises after comparatively longer period, i.e. normally at the time of redemption.

There is a variant of close ended scheme known as *Interval Scheme.* It is basically a close ended scheme with a peculiar feature that every year for a specified period (interval) it is made open. Prior to and after such specified interval the scheme operates as close ended. During the said period mutual fund is ready to buy or sell the units directly from or to the investors.

In India as per SEBI (MF) Regulations, every mutual fund is free to launch any or both types of schemes including interval scheme. In the USA, UK and Canada close ended funds are popular as investment companies/ trust whereas open ended funds are known as mutual funds. Such distinction is not made in Indian context. In those countries mutual funds are more popular than investment companies. Till 1994 mid, in India close ended funds were popular but later on investors' preference for open ended funds forced mutual funds to change their market product.

13.3.2 Return-Based Classification

To meet the diversified needs of investors, the mutual fund schemes are designed accordingly. Basically, all investments are made to earn good returns. Returns expected are in the form of regular dividends or capital appreciation or a combination of these two. In the light of this fact, mutual fund schemes can also be classified into three categories on the basis of returns.

Income Funds: For Investors who are more curious for regular returns, Income Funds are floated. Their object is to maximise current income. Investment is made in fixed income securities like bonds debentures. Such funds distribute periodically the income earned by them. These funds can further be splitted up into *two categories* i.e. those that target *constant income* at relatively low risk and those that attempt to achieve the *maximum income possible*, even with the use of leverage. Obviously the higher the expected return, the higher the potential risk of the investment.

Growth Funds: Such funds aim at appreciation in the value of the underlying investments through capital appreciation. Such funds invest in growth oriented securities i.e. in shares of companies which can appreciate in long run. Growth funds are also known as Nest eggs or Long haul investments. An investor who selects such fund should be able to assume a higher than normal degree of risk.

Conservative Fund: The funds with a philosophy of all things to all issue offer document announcing objectives as: (1) to provide a reasonable rate of return. (2) to protect the value of investment and, (3) to achieve capital appreciation consistent with the fulfillment of the first two objectives. Such funds which offer a blend of all these features are known as conservative fund. These are also known as *middle of the road funds*. Such funds divide their portfolio in common stocks and bonds in a way to achieve the desired objectives. Such funds have been most popular and appeal "to the investors who want both growth and income.

13.3.3 Investment-Base Classification

Mutual funds may also be classified on the basis of securities in which they invest. Basically, it is renaming the sub-categories of return-base classification.

Equity Fund: Such funds, as the name implies, invest most of their investible funds in *equity shares of companies* and undertake the risk associated with the investment in equity shares. Such funds are clearly expected to outdo other funds in a rising market, because these have almost all their capital in equity. A special type of equity fund is known as 'Index Fund' or 'Never beat market fund'. These are known as *Index funds* since these funds transact only those scrips which are included in any specific index e.g., the scrips which constitute the BSE-30 Sensex or 100 shares National index. Due to the overall poor performance of managed funds this type of fund has emerged. The fund consists of a portfolio designed to reflect the composition of some broad based market index and it is done by holding securities in the, same proportion as the index itself. The portfolio of the index fund is constructed in exactly the same proportion with respect to rupees involved. The value of such index linked funds will go up whenever the market index goes up and conversely, it will come down when the market index comes down. Such fund is not to beat a specific index but is to match that index. These funds have comparatively lower operating costs.

Bond Fund: Such funds have their portfolio consisting of *bonds*, *debentures*, etc. This type of fund is expected to be very secure with a steady income but with little or no chance of capital appreciation. Obviously risk is low in such funds. In this category we may come across the funds called *Liquid funds* which specialise in investing short-term money market instruments. The emphasis is on liquidity and is associated with lower risks and low returns.

Balanced Fund: The funds which have in their portfolio a reasonable *mix of equity and bonds* are known as balanced funds. Such funds will put *more* emphasis on equity share investments when the outlook is bright and will tend to switch to debentures when the future is expected to be poor for shares, majority of funds fall in this category, of course, their mix- proportion varies.

Fund of funds (FOF): It is a mutual fund scheme that invests in other mutual funds schemes instead of investing in securities. Such schemes are prevalent in international markets. These schemes can have different investment patterns and investment strategies as disclosed in offer documents. The investors may invest their funds in those FOF schemes which meet their investment objectives instead of investing in different schemes of a mutual fund and keeping track of their NAVs. Such FOF schemes may invest in other sector specific schemes or those schemes which have more weightage of certain stocks and can exit from those schemes when growth prospects of those sectors are not good. The investors putting their money in one sector specific scheme may not be able to decide when to exit.

13.3.4 Sector-Based Classification

There are number of funds that are directly investing in a specified sector of an economy. While such funds do have the disadvantage of low diversification by putting all their eggs in one basket, the policy of specialising has the advantage of developing in the fund managers an intensive knowledge of the specific sector in which they are investing. The specialised sectors can be (i) gold and silver, (ii) real estate, (iii) specific industry say oil and gas companies, (iv) off-shore investments, etc.

13.3.5 Leverage-Based Classification

Some mutual funds broad base their investible funds by borrowings from the market and then make investments thereby making leverage benefits available to the mutual fund investors. Such funds are known as *'leveraged funds'*. It depends on the regulating provisions in a country whether borrowings are allowed or not. Normally leverage funds use short sale, which allows the management of the fund to avail the advantage of declining markets in order to realise gains in the portfolio. Leverage funds also use options specifically *call options*.

13.3.6 Other Funds

There are some other types of schemes which do not fit into the above given classifications. Some of such funds are mentioned here. There are *'load funds'* and *'no-load funds'*. In load funds, the mutual funds charge a fee over and above the net asset value from the purchaser. In No load funds no load-fee is charged because little sales efforts are made to promote the fund's sales except through direct advertising. Mutual funds schemes can also be designed to offer some tax exemption. Besides these, there are *money market mutual funds* which interact only in money market. *Off-shore mutual funds (also known as regional or country funds)* are the funds mobilising funds abroad for deployment in local market. Many mutual funds abroad have floated property funds, art funds, commodity funds, energy funds, etc.

One point needs to be viewed that irrespective of classification of schemes, every scheme will be either an open ended scheme or a close ended scheme.

Activity 1

1) Contact some mutual fund investors and ask them why do they invest in mutual fund.

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2) Consult any financial newspaper and list *five* mutual fund schemes in operations in India under each of the following categories of schemes:

Growth:...

Income:...

Balanced:..

Sector-based:..

13.4 MUTUAL FUNDS IN INDIA

In India mutual fund concept took root only in the nineteen sixties, after a century old history elsewhere in the world. Reacting to the need for a more active mobilisation of household savings to provide investible resources to industry, the idea of first mutual fund in India i.e. UTI born out of the far sighted vision of Sri T. T. Krishnamachari, the then Finance Minister. UTI in 1964 started with a unit scheme popular as "US-64". Since Unit Trust of India was the result of a special enactment, no other open end mutual fund activities could emerge because of restrictive conditions of Indian Companies Act, 1956. Of course, close end investment companies existed for in-house investments as well as portfolio investment for a long time. But their activities were again on restricted scale.

In 1987 the monopoly of UTI came to an end when Government of India by amending Banking Regulation Act enabled commercial banks in Public sector to set up mutual funds as their subsidiaries. First of all State Bank of India got a nod from RBI. Next to follow was Canara Bank. It was the Abid Hussain Committee's unequivocal support to the concept that could be accepted as something of a landmark. It called for a greater number of mutual fund players. LIC and GIC also entered the field of mutual funds. During 1987-92, nine mutual funds came into being with investible resources Rs. 37000 crores. This .amount was only 4563 crores up to June 1987. Major share was of UTI.

In pre-1992 period, Indian mutual funds had certain peculiarities. These are:

- Mutual funds in our country till this period were public sector banks and financial institutions.
- Another distinguishing feature was that majority of mutual funds have been floated by commercial banks and financial institutions which gave the impression in the minds of investors that responsibility of funds lies with the respective banks thus, their investment is secured.
- One feature which distinguished mutual funds in India from their counterparts in Europe was that the latter normally do not have an in built promise of minimum return. The experience of UTI showed that its schemes with assured returns had tremendous success.
- Disclosure practices of mutual funds were far away from international standards despite the specific provisions in the regulatory framework.
- One of the important features of mutual fund success in raising respectable quantum of fund was the associated tax concessions.
- The launching of mutual funds by commercial banks during 1986-87 was in the peculiar circumstances of the absence of any regulatory framework for conduct of their affairs.

Unit Trust of India Act regulated only the affairs of UTI. Banking Companies Act guided commercial banking activities of banks. Indian Trust Act, under which new mutual funds were registered, was too general to take care of mutual fund characteristics. Thus a need for regulating mutual funds was felt. SEBI came out with Mutual Fund Regulation in 1993 under which all mutual funds, except UTI were to be registered and governed. Private sector was thrown open for this industry. With the entry of private sector funds in 1993, a new era started in the Indian mutual fund industry, giving the Indian investors a wider choice of fund families. The 1993 SEBI (Mutual Fund) Regulations were substituted by a more comprehensive and revised Mutual Fund Regulations in 1996.

The industry now functions under the SEBI (Mutual Fund) Regulations 1996. The number of mutual fund houses went on increasing, with many foreign mutual funds setting up funds in India and also the industry has witnessed several mergers and acquisitions. As at the end of January 2003, there were 33 mutual funds with total assets of Rs. 1,21,805 crores. The Unit Trust of India with Rs.44,541 crores of assets under management was way ahead of other mutual funds.

In February 2003, following the repeal of the Unit Trust of India Act 1963 UTI was bifurcated into two separate entities. One is the *Specified Undertaking of the Unit Trust of India* with assets under management of Rs.29,835 crores as at the end of January 2003, representing broadly, the assets of US 64 scheme, assured return and certain other schemes. The Specified Undertaking of Unit Trust of India, functioning under an administrator and under the rules framed by Government of India does not come under the purview of the Mutual Fund Regulations. The second is the *UTI Mutual Fund Ltd*, sponsored by SBI, PNB, BOB and LIC. It is registered with SEBI and functions under the Mutual Fund Regulations. With the bifurcation of the erstwhile UTI and with recent mergers taking place among different private sector funds, the mutual fund industry has entered its current phase of consolidation and growth. As on 31st March 2004 the vital statistics for this industry was as shown in Tables 13.1 and 13.2 which highlight the fact that about 35 per cent of the funds are as open ended and about 50 per cent funds are in income schemes. This statistics also show that only 20 per cent of the funds are with public sector funds and 80 percent are with private sector.

Table 13.1: Assets under Management as on 31st March, 2004 (Rs. in crore)

Mutual Fund	Open Ended	Close Ended	Assured return	Total
Income	60854	1670	-	**62524**
Growth	22154	1459	-	**23613**
Balanced	3296	784	-	**4080**
Liquid/Money Market	41704	-	-	**41704**
Gilt	6026	-	-	**6026**
ELSS	489	1180	-	**1669**
Total	**134523**	**5093**	-	**139616**

Table 13.2: Assets under Management as on 31st March, 2004

Sl. No.	Name of the Company	Asset Management	Asset Under Management (Rs. in Crores)
A	BANK SPONSORED		
	BOB Asset Management Co. Ltd.		454
	Canbank Investment Management Services Ltd.		1698
	PNB Asset Management Co. Ltd.		114
	SBI Funds Management Ltd.		5202
	UTI Asset Management Company Pvt. Ltd.		20617
	Total A		**28085**

B	INSTITUTIONS	
	GIC Asset Management Co. Ltd.	234
	IL & FS Asset Management Co. Ltd.	2096
	Jeevan Bima Sahayog Asset Management Co. Ltd.	4209
	Total B	**6539**
	PRIVATE SECTOR	
C	(i) INDIAN	
	Benchmark Asset Management Co. Pvt. Ltd.	71
	Cholamandalam Asset Management Co. Ltd.	1125
	Escorts Asset Management Ltd.	156
	Sahara Asset Management Co. Pvt. Ltd.	349
	J.M.Capital Management Pvt. Ltd.	3644
	Kotak Mahindra Asset Management Co. Ltd.	5290
	Reliance Capital Asset Management Ltd.	7241
	Sundaram Asset Management Company Ltd.	2009
	Total C(i)	**19885**
C	(ii) FOREIGN	
	Principal Asset Management Co. Pvt. Ltd.	3633
	Total C(ii)	**3633**
C	(iii) JOINT VENTURES – PREDOMINANTLY INDIAN	
	Birla Sun Life Asset Management Co. Ltd.	8873
	Credit Capital Asset Management Co. Ltd.	144
	DSP Merrill Lynch Fund Managers Ltd.	5127
	HDFC Asset Management Co. Ltd.	14985
	Tata TD Asset Management Private Ltd.	4014
	Total C(iii)	**33143**
C	(iv) JOINT VENTURES – PREDOMINANTLY FOREIGN	
	Alliance Capital Asset Management (India) Pvt. Ltd.	2091
	Deutsche Asset Management (India) Pvt. Ltd.	2073
	HSBC Asset Management (India) Private Ltd.	4528
	ING Investment Management (India) Pvt. Ltd.	1553
	Morgan Stanley Investment Management Pvt. Ltd.	1361
	Prudential ICICI Asset Management Co. Ltd.	14057
	Standard Chartered Asset Mgmt Co. Pvt. Ltd.	7287
	Sun F & C Asset Management (India) Pvt. Ltd.	194
	Franklin Templeton Asset Management (India) Pvt. Ltd.	15187
	Total C (iv)	**48331**
	Total C (i + ii + iii + iv)	**104992**
	Total (A + B + C)	**139616**

(**Source:** web site of AMFI www.amfiindia.com)

13.5 CONSTITUTION OF MUTUAL FUNDS

In USA and UK, mutual funds and the unit trusts are governed by the Investment Act of 1940 in USA and by the Prevention of Frauds Act in UK. There are normally three agencies to manage the show of mutual funds: first the Investment Adviser, second the agency collecting savings from prospective investors for a commission; and the third is a trustee which is either a banking or insurance company. The investment adviser is accountable to the trustees for its operations and ultimately to the Securities Exchange Commission (SEC) in USA or to the Securities Investment Board (SIB) in UK. For comparison, constitution of mutual fund as operating in USA and India are explained here:

In USA

A mutual fund is organized either as a corporation or a business trust. Individuals and institutions invest in a mutual fund by purchasing shares issued by the fund. It is through these sales of shares that a mutual fund raises the cash used to invest in its portfolio of stocks, bonds, and other securities. A mutual fund is typically externally managed: it is not an operating company with employees in the traditional sense. Instead, a fund relies upon third parties, either affiliated organizations or independent contractors, to carry out its business activities, such as investing in securities.

Board of Directors Oversees the fund's activities, including approval of the contract with the management company and certain other service providers.

Investment adviser Manages the fund's portfolio according to the objectives and policies described in the fund's prospectus.

Administrators

Administrative services may be provided to a fund by an affiliate of the fund, such as the investment adviser, or by an unaffiliated third party. Administrative services include overseeing the performance of other companies that provide services to the fund and ensuring that the fund's operations comply with legal requirements. Typically, a fund administrator pays for office costs and personnel, provides general accounting services, and may also prepare and file SEC, tax, shareholder, and other reports.

Principal Underwriters

Most mutual funds continuously offer new shares to the public at a price based on the current value of fund net assets plus any sales charges. Mutual funds usually distribute their shares through principal underwriters. Principal underwriters are regulated as brokers, dealers and are subject to NASD rules governing mutual fund sales practices.

Custodians

Mutual funds are required by law to protect their portfolio securities by placing them with a custodian. Nearly all mutual funds use qualified bank custodians. The SEC requires mutual fund custodians to segregate mutual fund portfolio securities from other bank assets.

Transfer Agents

A transfer agent is employed by a mutual fund to maintain records of shareholder accounts, calculate and disburse dividends, and prepare and mail shareholder account statements, federal income tax information, and other shareholder notices. Some transfer agents prepare and mail statements confirming shareholder transactions and account balances, and maintain customer service departments to respond to shareholder inquiries.

In India

SEBI, in its regulations contemplated a four-tier system for managing the affairs of Indian mutual funds ensuring arm's length distance between the sponsor and the fund. Since mutual fund is a specialised type of financial institution which acts as investment conduit for investors at large especially the small investors, the authorities are concerned about the investors' safeguards. Accordingly SEBI regulations are drafted to give a specific direction to the constitution and management of mutual funds. These provisions are designed to safeguard investors, check speculative activities of mutual funds and ensuring financial discipline through transparency and fair play. Regarding constitution, SEBI (Mutual Fund) Regulations require a *four tier system* to organise mutual fund, these being Sponsor, Trustee, Assets Management Company and Custodian.

13.5.1 Sponsors

It refers to any body corporate which initiates the launching of a mutual fund. It is this agency which of its own, if eligible, or in collaboration with other body corporate complies the formalities of establishing a mutual fund. The sponsor should have a sound track record and experience in the relevant field of financial services for a minimum period of 5 years. SEBI ensures that sponsors should have professional competence, financial soundness and general reputation of fairness and integrity in business transactions. Every mutual fund shall be registered under the said regulations and it is the sponsor who files an application (format is prescribed) with fee to SEBI. Sponsor is also to contribute at least 40 per cent of the net worth (Rs. 4 crore) of the Asset Management Company. It is the sponsors who identify and appoint the trustees and AMC. Sponsors are to appoint a board of trustees as well as to get the AMC incorporated. It is the duty of sponsors to submit to SEBI the trust deed and draft of memorandum and Articles of Association of AMC. Once MF is registered, the sponsors technically go in background.

13.5.2 Trustees

A mutual fund is to be constituted as a Trust under Indian Trust Act and trustees are to look after the trust. A trustee is a person who holds the property of the mutual fund in trust for the benefit of the unit holders. A company is appointed as a trustee to manage the mutual fund with approval of SEBI. To ensure fair dealings, at least 75 per cent of the trustees are to be independent of the sponsors. Trustees take into their custody, or under their control all the property of the schemes of mutual fund. It is the duty of the trustees to provide information to unit holders as well as to SEBI about the mutual fund schemes. Trustees are to appoint Asset Management Company (AMC) to float the schemes. The trustees are to evolve Investment Management Agreement to be entered into with AMC. It is trustee's duty to observe and ensure that AMC is managing schemes in accordance with the trust deed. Trustees can dismiss the appointed AMC. It is the responsibility of trustees to supervise the collection of any income due to be paid to the scheme. Trustees for their services are paid trusteeship fee which is to be specified in the trust deed. Trustees are to present annual report to the investors.

Mutual fund is basically a principal - agent problem where the principle is unit holder who hires an agent i.e., mutual fund (trustees) and the principal tries to ensure and expects that actions of the agent are in the best interest of the former. Mutual funds by nature are custodians of the money of investors (specially the small investors who do not excel in investment activities) entrusting their savings in the belief that the former have better expertise and skills for investing than of their own. The task of keeping up this trust is by no means easy. This makes mutual funds different from other businesses and their well-being and health reflects the health of investment climate. Mutual fund is created by a sponsor as a trust under *Indian Trust Act 1882,*

and registered under SEBI. A trustee is appointed who holds the property of the mutual fund in trust for the benefit of the unit holders. Once the mutual fund trust is formed, the role of sponsor virtually becomes nil as it is the trust which now interacts with SEBI.

SEBI regulations desire appointing a trustee either as individuals, comprising a board of trustee, or a trustee company. Traditionally mutual funds have been operating with a board of trustees but some new entrants in this field have opted for a company to be appointed as a trustee to manage the mutual fund. The main reason why a trustee company is preferred over a board of trustees is that in their individual capacity, board of trustees have an unlimited liability. Consequently, their personal property may be at stake if a scheme fails. Where as for trustee company board of directors have limited liability.

Trustees, are regulated by a Trust- Deed which is to be submitted to SEBI. The trustees are to manage the Mutual Fund in accordance with the laws, regulations, directions and guidelines issued by SEBI, the stock exchanges and other governmental and regulatory agencies. They are to hold in safe custody and preserve the mutual fund's property. Trustees are to report on operations to SEBI and the Unit holders. They are to ensure that AMC has been diligent in conducting the affairs. The trustees' working has been made subject to a code of conduct.

To ensure fair dealings, mutual fund regulations require that one cannot be a trustee or a director of a trustee company in more than one mutual fund. Further, at least *two- third* of the trustees are to be *independent* of the sponsors. These *independent trustees,* of course*, enjoy multi trusteeship.* Asset management company or its directors or employees shall not act as trustees of any MF. Trustees should be persons with experience in financial services. Every trustee should be a person of ability, integrity and standing. Trustees appoint Asset Management Company (AMC) to float the schemes in consultation with sponsors. The trustees are to evolve *Investment Management Agreement* (IMA) to be entered into with AMC. It is trustee's duty to observe and ensure that AMC is managing schemes in accordance with the trust deed.

Trustees can dismiss the AMC. It is the responsibility of trustees to supervise the collection of any income due to be paid to the scheme. Trustees for their services are paid trusteeship fee which is to be specified in the trust deed. Trustees are to present annual report to the investors. They can call a meeting of the unit holders if a requisition is filed. Rights and obligations of the trustees under SEBI (Mutual fund) Regulations along with **due diligence** (general and specific) are as under:

Rights and Obligations of the Trustees ‘

1) The trustees and the asset management company shall with the prior approval of the Board enter into an investment management agreement.
2) The investment management agreement shall contain such clause as are mentioned in the regulations and such other clauses as are necessary for the purpose of making investments.
3) The trustees shall have a right to obtain from the asset management company such information as is considered necessary by the trustees.
4) The trustees shall ensure before the launch of any scheme that the asset management company has:
    a) systems in place for its back office, dealing room and accounting;
    b) appointed all key personnel including fund manager(s) for the scheme(s) and submitted their bio-data which shall contain ‘the educational qualifications, past experience in the securities market with the trustees, within 15 days of their appointment.

c) appointed auditors to audit its accounts.

d) appointed a compliance officer who shall be responsible for monitoring the compliance of the Act, rules and regulations, notifications, guidelines, instructions, etc. issued by the Board or the Central Government and for redressal of investors' grievances.

e) appointed registrars and laid down parameters for their supervision.

f) prepared a compliance manual and designed internal control mechanisms including internal audit systems

g) specified norms for empanelment of brokers and marketing agents.

4A) The compliance officer shall immediately and independently report to the Board any non-compliance observed by him.

5) The trustees shall ensure that an asset management company has been diligent in empaneling the brokers in monitoring securities transactions with brokers and avoiding undue concentration of business with any broker.

6) The trustees shall ensure that the asset management company has not given any undue or unfair advantage to any associates or dealt with any of the associates of the asset management company in any manner detrimental to interest of the unit-holder.

7) The trustees shall ensure that the transactions entered into by the asset management company are in accordance with these regulations and the scheme.

8) The trustees shall ensure that the asset management company has been managing the mutual fund schemes independently of other activities and have taken adequate steps so that the interest of investors of one scheme,are not being compromised with those of any other scheme or of other activities of the asset management company.

9) The trustees shall ensure that all the activities of the asset management company are in accordance with the provisions of these regulations.

10) Where the trustees have reason to believe that the conduct of business of the mutual fund is not in accordance with these regulations and the scheme they shall forthwith take such remedial steps as are necessary by them and shall immediately inform the Board of the violation and the action taken by them.

11) Each trustee shall file the details of his transactions of dealing in securities with the Mutual Fund on a quarterly basis.

12) The trustees shall be accountable for, and be the custodian of, the funds and property of the respective schemes and shall hold the same in trust for the benefit of the unit-holders in accordance with these regulations and the provisions of trust deed.

13) The trustees shall take steps to ensure that the transactions of the mutual fund are in accordance with the provisions of the trust deed.

14) The trustees shall be responsible for the calculation of any income due to be paid to the mutual fund and also of any income received in the mutual fund for the holders of the units of any scheme in accordance with these regulations and the trust deed.

15) The trustees shall obtain the consent of the unit-holders:

a) whenever required to do so by the Board in the interest of the unit holders; or

b) whenever required to do so on the requisition made by three-fourth of the unit-holders of any scheme; or

c) when the majority of the trustees decide to wind up or prematurely redeem the units; or

15A) The trustees shall ensure that no change in the fundamental attributes of any scheme trust or fees and expenses payable or any other change which would modify the scheme and affects the interest of unit-holders shall be carried out.

16) The trustees shall call for the details of transactions in securities by the key personnel of the asset management company in his own name or on behalf of the asset management company and shall report to the Board; as and when required.

17) The trustees shall quarterly review all transactions carried out between the mutual funds, asset management company and its associates.

18) The trustees shall quarterly review the net worth of the asset management company and in , case of any shortfall, ensure that the asset management company make up for the shortfall.

19) The trustees shall periodically review all service contracts such as custody arrangements, transfer agency of the securities and satisfy itself that such contracts are executed in the interest of the unit-holders.

20) The trustees shall ensure that there is no conflict of Interest between the manner of deployment of its net worth by the asset management company and the interest-of the unit-holders.

21) The trustees shall periodically review the investor complaints received and the redressal of the same by the asset management company.

22) The trustees shall abide by the **Code of Conduct** as specified **(*see Annexure 4*)**

23) The trustees shall furnish to the Board on a half-yearly basis.

   a) a report on the activities of the mutual fund:

   b) a certificate stating that the trustees have satisfied themselves that there have been no instances of self-dealing or front running,

   c) a certificate to the effect that the asset management company has been managing the scheme independently of any other activities.

24) The independent trustees shall give their comments on the report received from the asset management company regarding the investments by the mutual fund in the securities of group companies of the sponsor.

25) Trustees shall exercise **due diligence** as under:

A) ***General Due Diligence***

i) The Trustees shall be discerning in the appointment of the directors on the Board of the asset management company.

ii) Trustees shall review the desirability of continuance of the asset management company if substantial irregularities are observed in any of the schemes and shall not allow the asset management company to float new schemes.

iii) The trustee shall ensure that the trust property is properly protected, held and administered by proper persons and by a proper number of such persons.

iv) The trustee shall ensure that all service providers are holding appropriate registrations from the Board or concerned regulatory authority.

v) The Trustees shall arrange for test checks of service contracts.

vi) Trustees shall immediately report to Board of any special developments In the mutual fund.

B) ***Specific Due Diligence***

The Trustees shall:

i) Obtain internal audit reports at regular intervals from independent auditors appointed by the Trustees;

ii) obtain compliance certificate at regular intervals from the asset management company;

iii) hold meeting of trustee more frequently;

iv) consider the reports of the independent auditor and compliance reports of asset management company at the meetings of trustees for appropriate action;

v) maintain records of the decisions of the Trustees at their meetings and of the minutes of the meetings;

vi) prescribe and adhere to a code of ethics by the Trustees, asset management company and its personnel; .

vii) communicate in writing to the asset management company of the deficiencies and checking on the rectification of deficiencies.

26) The trustees shall not be held liable for acts done in good faith if they have exercised adequate due diligence honestly.

27) The independent directors of the trustees or asset management company shall pay specific attention to the following as may be applicable. Namely:

i) the Investment Management Agreement and the compensation paid under the agreement;

ii) service contracts with affiliates – whether the asset management company has charged higher fees than outside contracts for the same services;

iii) selection of the asset management company's independent directors;

iv) securities transactions involving affiliates to the extent such transactions are permitted;

v) selecting and nominating individuals to fill independent directors vacancies;

vi) code of ethics must be designed to prevent fraudulent deceptive or manipulative practice by insiders in connection with personal securities transactions;

vii) the reasonableness of fees paid to sponsors, asset management company and any other for services provided;

viii) principal underwriting contracts and their renewals;

ix) any service contract with the associates of the asset management company.

13.5.3 Custodians

In a mutual fund depending on its size there is substantial work involved in managing the scrips bought from and sold in the market. Their safe custody and ready availability is to be ensured. SEBI requires that each mutual fund shall have a custodian who is not in any way associated with the Asset Management Company. Such custodian cannot act as sponsor or trustee of any mutual fund. Further, custodian is not permitted to act as a custodian to more than one mutual fund without the prior approval of SEBI. A custodian's main assignment is safekeeping of the securities or participation in any clearing system on behalf of the client to effect deliveries of the securities. The custodian, depending on terms of agreement, also

collects income/dividends on the securities. Some of the other associated assignments of custodians are:

- Ensuring delivery of scrips only on receipt of payment and payment only upon receipt of scrips.
- Regular reconciliation of assets to accounting records.
- Timely resolution on discrepancies and failures.
- Securities are properly registered or recorded.

Depending on the volume there can be co-custodian(s) for a mutual fund. These custodians are entitled to receive custodianship fee, based on the average weekly value of net assets or sale and purchases of securities along with per certificate custody charges.

13.5.4 Assets Management Company (AMC)

The sponsor or the trustees appoint an AMC, also known as 'Investment Manager', to manage the affairs of the mutual fund. It is the AMC which operates all the schemes of the fund. Any AMC cannot act as a trustee of any other mutual fund. AMC can act as an AMC of only one mutual fund. AMC is not permitted to undertake any business activity except activities in the nature of management and advisory services to off shore funds, pension funds, provident funds, venture capital funds, management of insurance funds, financial consultancy and exchange of research on commercial basis, if these activities are not in conflict with the activities of the mutual fund. It can also operate as an underwriter provided it gets registered under SEBI (Merchant Bankers) Regulations. SEBI regulations in this matter are as under:

The asset management company shall

1) not act as a trustee of any mutual fund;
2) not undertake any other business activities expect activities in the nature of portfolio management, services management and advisory services to offshore funds, pension funds, provident funds, venture capital fund, management of insurance funds. Financial consultancy and exchange of research on commercial basis if any of such activities are not in conflict with the activities of the mutual funds. (Asset management company shall meet capital adequacy requirements, if any, separately for each such activity and obtain separate approval, if necessary under the relevant regulations);
3) not investment in any of its schemes unless full disclosure of its intention to invest has been made in the offer documents an asset management company shall not be entitled to charge any fees on its investment in that scheme.

SEBI desires that assets management company should have a sound track record (good net worth, dividend paying capacity and profitability, etc.), general reputation and fairness in transaction. The directors of AMC should be expert in relevant fields like portfolio management, investment analysis and financial administration because any AMC is basically involved in these three activities. An AMC is expected to operate independently. SEBI regulations require that at least fifty per cent of the directors should be those who do not have any association with sponsor or trustees, Its Chairman should be an independent person. To ensure stake of sponsors in the AMC, it is required that atleast 40 per cent of its net worth is contributed by the former, AMC, itself should be financially sound and should have a net worth of at least Rs. 10 crores. All these provisons are to ensure good governance of mutual funds in India.

Working Mechanism of AMC

The major strength of any AMC lies in its investment function. Investment function is a specialised function which, depending on operational strategies of AMCs, can further be divided into specialised categories. The Investment Department operates with the following set up:

Fund Manager: Asset Management Companies manage the investment of funds through a fund manager. The basic function of a fund Manager is to decide about which, when, how much and at what rate securities are to be sold or bought. To a great extent the success of any scheme depends on the caliber of the fund manager.

For many mutual funds especially in bank sponsored funds, the entire investment exercise is not left to one individual. They have created committees to handle their investments. One such mutual fund has created two committees. First is 'Investment Committee' which is a broad based committee having even nominees of the sponsor. It decides about the primary market investments. The second is a Market Operation Committee having the assignment of disinvestments and interacting with secondary market. It is normally an in-house committee. These committees also make their judgments on the basis of data provided by the research wing.

Research and Planning Cell: It performs a very sensitive and technical assignment. Depending on the operational policies, such unit can be created by AMC on its own or research findings can be hired from outside agencies. The research can be with respect to securities as well as prospective investors. The fund manager can contribute to the bottom line of mutual fund by spotting significant changes in securities ahead of the crowd. In India, at present many funds depend on outsiders. Such outsiders need not be technical analyst, even brokers provide tips to mutual funds. Such a strategy saves a lot of funds to be invested in research infrastructure. The new mutual funds with small corpus can hardly afford to have their own data base. But there are mutual funds following the philosophy; your expertise is your original research.

Dealer: To execute the sale and purchase transactions in capital or money market, a separate section may be created under the charge of a person called dealer having deep understanding of stock market operations. Sometimes, this division is under the charge of marketing division of AMC. Dealer is to comply with all formalities of sale and purchase through brokers. Such brokers are to be approved by Board of Directors (B.O.D.) of AMC. It is B.O.D. which lays down the guidelines for allocation of business to different brokers.

Functions of AMC

It is not required that AMC performs all its functions on its own. It can hire services of outside agencies as per its requirements Some of the common functions performed by mutual funds are listed below:

a) One of the main functions of mutual fund is receiving and processing the application forms of investors, issuing unit certificates, sending refund orders, recording all transfers of units and maintaining all such records, repurchasing the units, redemption of units, issuing dividend or income warrants. If the volume of work is huge and needs specialized expertise, mutual funds may engage the services of *Registrars and Transfer Agents*. For such services they are entitled to a fee which is in proportion to the number of unit-holders and number of transactions, etc. Such fee is charged by AMC from the mutual fund and is paid to the agents.

b) Computing the net asset value per unit of the scheme, maintaining its books and records, maintaining compliance with the schemes investment limitations as well as the SEBI Regulations and other regulations, preparing and distributing reports on the scheme of the unit holders and SEBI and maintaining the performance of

mutual funds custodians, recording all accounting transactions maintaining their records etc. is another group of activities under taken which can be termed as *Fund Accounting.* Again depending on the size of the fund, its age and number of expected transactions *Fund Accounting* may be assigned to specialised agencies. In India, in the absence of rigorous accounting norms, this service hardly availed of outsiders but in times to come outside agencies will be required.

c) Activities of intermediaries such as advertising agency, printers, collection centres and marketing of the services are to be coordinated. Mutual funds as per their judgment instead of performing these activities generally engage *Lead Managers* . They get fees on the basis of funds mobilised. They are normally engaged by AMCs for extensive campaign about the scheme to attract the investors. They are also called marketing associates. Outside agencies engaged for such assignment have to comply with the advertising code specified by SEBI for MFs. They assist AMC to approach potential investors through meetings, exhibitions, contacts, advertising, publicity, sales promotion etc.

d) AMCs have to design their investment strategies on a continuous basis. If they can not cope up with workload, *Investment Advisors* may be appointed by AMC. Investment advisors analyse the market and provide advice to the AMC as and when required. For their professional advice on funds investment, they are entitled to receive compensation normally based on the average weekly value of the funds net assets. Majority of Indian Mutual Funds have their own market analysts who design their investment strategies.

e) A lot of legal exercise is undertaken during the planning and execution of different schemes. A group of advocates and solicitors may be appointed as legal advisors. Their fee is in no way associated with net assets of the fund but actual fee is paid to them as decided. Assets Management Company is also required to have an auditor, who is not an auditor of the mutual fund, to undertake independent inspection and verification of its accounting activities.

Activity 2

a) Get hold of offer document of any mutual fund scheme and study:

i) Features of its AMC.

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ii) Its Custodian Service Agreement.

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iii) Duties of its Trustees.

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b) Collect offer documents of five mutual funds and list their sponsors, trusts, AMCs and Custodians.

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13.6 MANAGING A MUTUAL FUND

An insight into the management of a mutual fund scheme can be had from Chart 13.1 which identifies broad activities involved in launching and managing a scheme. It is not a conclusive list of activities but highlights the major activities. Moreover, the sequence of the activities is not perfect since many of the activities may be performed simultaneously. Depending on the strategies some of the specified activities may be performed by some outside agencies. AMCs can have different sections to perform a separate set of specified activities. Different sections can be General Administration, Accounts, Investment, Marketing, Research and Secretarial. On the basis of activities in Chart 13.1 an AMC may evolve ‘Pre-Issue department and Post-Issue department besides a General Administration department’.

Chart 13.1: Synoptic View of Activities in Launching and Managing a MF Scheme

Pre-Issue

*General Administration:*Designing scheme features by planning department in consultation with marketing department.

Getting clearance from the Board of Trustees.

Follow-up with SEBI .

Opening of new accounts and separate books of accounts for each scheme.

Appointment of Registrar to the scheme, custodian and collecting bankers/centers

Marketing:

Evolve marketing strategies and engaging services of advertising agencies.

Printing of required stationery, offer documents and application forms, etc.

Advertisement campaign is launched.

Distribution of offer document and application.

Printing of unit certificates, allotment letters, etc. and sending these to Registrar to the issue.

Opening of schemes and collection by centres.

Collections received by Head Office along with application forms which are passed on to the Registrar to the Issue.

Post-Issue

Secretarial:

Application for listing, if necessary

Registrar prepares the records and sends allotment letters and or unit certificates to investors

Sending relevant records to investor centres

Payments of commission to agencies engaged

Settling customers complaints

Regular disclosures made at desired intervals

Investment:

Operating a Scheme

Short-term call-money market investments starts

Order for procuring investment from market by Investment Department as per investment plans

Payments released by Accounts department from respective accounts for investments made

Delivery of investment documents to the custodians.

Sale of investments and payments received

Reconciliation of investments as per the books and as per the physical documents with custodians .

Subsequent sale and purchase of units. (only in open ended scheme)

Receiving incomes e.g. profits on sale of investments, dividends, interest, underwriting commission, etc. from companies.

***Accounts*:**

Compilation of expenses for operating the scheme

Final accounts prepared by Accounts Department

Proposal for dividend prepared by Accounts Department in consultation with department engaged in business development and marketing

Approval of dividend by Board of Trustees

Final Accounts audited and adopted

Dividend warrants sent to Unit Holders'

Post-issue process continues for open-ended schemes'

13.7 PORTFOLIO MANAGEMENT PROCESS

Portfolio management involves four steps:

a) setting investment goal of scheme;

b) identification of specific securities;

c) portfolio designing; and

d) revising the portfolio.

a) **Setting Investment Goal of Scheme:** The ultimate goal of a mutual fund scheme is to serve the investor in the best possible way. Thus, to set up its investment goals a mutual fund has to study its investors' perception and requirements. One class of investor may like to take higher risks and the other class of investors want to play safe with an eye on appreciation too. The mutual fund manager has to evolve a portfolio and set investment goals through a process of compromising in a way which satisfies majority of clients which the scheme aims at. It is impossible for mutual funds to perfectly match the objectives of its portfolio design to the expectation and risk-taking capacities of each and every individual. That is why in such situation comparatively bigger investors go in for portfolio managers instead of mutual funds. This is one reason why mutual funds are said to be friendly with medium and small investors.

b) **Identifying Specific Securities:** Once the goal of a scheme is clearly spelled out, the fund manager has to involve himself in security analysis to identify securities which can be combined to meet the goal requirements. For each security, risk and return characteristics are evaluated in broader perspective. In this process some

times, the fund manager or advisor first analyses each industry and then identifies specific scrips in specific industry. In practice, it is impossible for a fund manager to evaluate each and every security. Therefore, they may restrict their analysis exercise to those securities which prima facie have a good chance of being included in the final portfolio.

c) **Portfolio Designing:** For no two schemes same investment portfolio can be followed. So far as the broad portfolio mix is concerned it is specified by the fund manager while launching a scheme. But more important is the mix to be given shape practically, with shares, debentures etc. to be bought, how much and when are some of the very crucial questions to be answered. To answer these questions. fund managers have to do a lot of research. Gathering reliable and dependable information is significant. Market participants that do nothing to enhance their knowledge of financial conditions and prospects of firms are certainly to be on the unprofitable side of trade vis-à-vis participants that update their information regularly. It is on the basis of this information they can chalk out their long-term and short-term investment strategies. Building the portfolio follows the identification of specific securities. A fund manager tries to create a well-diversified portfolio of securities to reduce significantly unsystematic risk. His effort is to associate expected returns on individual security and portfolio as a whole with market or systematic risk.

To maintain liquid resources in the scheme a part of the scheme corpus is invested in money market instruments. Daily surplus cash resources are earmarked after setting aside money for expenses and primary/secondary market purchases. These can be deployed in one market. Surplus which may not be required overnight are invested in other instruments like government securities, commercial papers, certificates of deposits, treasury bills etc.

Mutual funds in India are to some extent regulated even for building their portfolio. MFs can invest only in rated debt instruments. They cannot invest in unlisted securities. No mutual fund should own more than 10 per cent of any company's paid up capital carrying voting rights. Every scheme is permitted to invest in other schemes of the same MF but not exceeding 5 per cent of net asset value. Investment can be made only in transferable securities in money market or capital market. Till end 1997 Indian mutual funds were permitted to invest only in Indian markets but after RBI's green signal now mutual funds have been permitted to invest in foreign markets up to a prescribed limit without any prior permission.

d) **Reviewing the Portfolio:** Once build up, portfolio may not be continued for all times to come since the risk return characteristics of all securities go on changing with time. In a dynamic investment world it is somewhat natural that once designed portfolio may not perform as desired. Further, new securities may be introduced in the market and old one may be shunted out. Thus, to stick to a portfolio by mutual fund is not desirable. To maximise the return on investment, all possible favourable opportunities are to be availed thus a turnover in the portfolio is a must.
What should be the turnover is a difficult question to answer. In an income-oriented scheme. turnover may be lesser as compared to growth oriented scheme. Depending- on the perception of the investment committee or fund manager, a part of portfolio is fixed and remaining is used for trading. Whether the fund manager reviews the portfolio mix in routine or due to external factors, every time a fresh risk-return exercise is undertaken for the whole portfolio to evaluate the desirability of the mix.

Activity 3

1) Consult office of any mutual fund or agents of mutual fund and enquire about portfolio management practices of different mutual funds.

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2) Collect application forms for any five schemes and study their investment goals.

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3) Compare investment portfolio of four growth schemes.

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13.8 OPERATIONAL EFFICIENCY OF MUTUAL FUNDS

Performance of a mutual fund should be measured against its stated objectives. If the fund's goal is to produce maximum current income, it will be the main factor for evaluation. If the objective is obtaining capital gains without emphasis on dividend income, then this will be the important factor to be measured. Traditionally, . the performance of a mutual fund is measured in India by summing the effect of two different things (1) changes in the net asset value(NAV) or market value, and (2) the amount of income dividends paid. This information is usually provided annually as an index of performance. This index may be compared to stock averages, or to an index of performance of other mutual funds. The periodic disclosures, annual reports and the prospectus of the mutual funds provide performance information in varying degrees of detail. Let us discuss some such parameters:

Net Asset Value (NAV)

NAV of a scheme indicates the intrinsic value of a unit under the scheme. It is the value which the unit holder can hope to get, if the scheme is wound up at the moment and all assets and liabilities are liquidated.

NAV per unit = (a – b) /c

Where:

a is total market value of investment portfolio, total written down value of fixed assets and the cost value of other current assets.

b is Current liabilities

c is Number of outstanding units in that scheme.

NAV depends upon the valuation of the portfolio of the mutual fund. Higher valuation inflates NAV and under valuation lowers the NAV. NAV is relevant in the context of a particular date. Mutual funds in past have been playing with NAV figure favouring one set of investors and putting others at loss just by virtue of valuation practices. Thus, valuation criterion of the investment portfolio has been spelled out by SEBI in 1996 regulations **(*See Annexure 1*).** NAV is to be calculated every day for open ended scheme and at least once a week for close ended scheme.

Load

Initial expenses incurred by a scheme is referred to as load of the scheme. If a scheme bears this load it is known as load scheme. It has been mentioned earlier SEBI permits every scheme to write off a maximum of 6 per cent of its corpus as initial expenses thus load can be up to 6 per cent only. On account of this load (say whole 6 per cent is load) Rs. 100 invested in a scheme give Rs. 94 to the fund manager to invest. As a result mutual fund units generally quote below par on listing. In a no load scheme this load is borne by the AMC and is not charged to the scheme. Thus, the entire amount mobilised gets invested in the scheme and is reflected in higher NAV. Hence 'no-load' schemes are gaining popularity.

Disclosures

Operational efficiency can also be disclosed through half yearly results and annual report. SEBI has spelled out for mutual funds the formats of Annual Report, Half-yearly financial results Report, Balance Sheet, Revenue Account (You may consult the Regulations). Distribution of annual reports of Scheme is obligatory. MFs are to disclose their portfolio to increase transparency in their operations. Investors are disclosed historical per unit statistics for three years by MFs. Facts regarding gross income per unit, per unit ratio of expenses to average net asset by percentage, per unit gross income to average net asset by percentage, etc., are also to be disclosed as desired by SEBI.

Returns

Mutual funds primarily serve the investors by providing returns on the investment by the latter. Returns are earned in form of (a) appreciation in value of investments made by mutual funds and (b) dividend or interest received on the investment made. Such returns of mutual funds are subject to expenses incurred, by them. SEBI, to protect interest of investors, desires through its regulations that such expenses incurred should be reasonable. These expenses can be trusteeship fee, management fee, administrative expenses, fund accounting fee, custodian fee, initial charges, etc.

SEBI has laid down limits on certain specific expenses and besides that an over all limit on expenses are fixed. AMC can charge management fee up to 1.25 per cent of weekly average net asset if such assets are up to Rs. 100 crore in a year and one per cent if these assets exceed Rs. 100 crore. This limit is increased up to additional one per cent if AMC is managing a no load scheme. Further, AMC cannot charge from mutual fund initial expenses of launching a scheme exceeding 6 per cent. SEBI, still further requires that over all expenses excluding expenses of issue or redemption shall not exceed 2.5 per cent on first Rs. 100 crore of average weekly net assets, 2.25 per cent on next Rs. 300 crores, 2 per cent on next Rs. 300 crores and 1.75 per cent on balance of the assets.

All these limits prescribed by SEBI are the maximum that a mutual funds can charge but practice in India had been that they charge these as such assuming these to be the minimum limit. When investors are not provided sufficient returns, they blame AMC for charging fee and expenses irrespective of returns to them. But one should not forget that if AMC continues to charge maximum permissible fee without providing reasonable returns to investors, investors may not subscribe to their schemes in future. SEBI has permitted MFs to assure returns to investors provided AMC stands guarantee to it on its own or its sponsor.

A common way of measuring the performance of a mutual fund management is by comparing the yields of the mutual fund, i.e. the managed portfolio, with the market or with a random portfolio. The portfolio yield is also calculated like the holding period yield where; NAVx is net asset value per share at the end of year x ,Dx is the total of all distributions per unit during the year x and NAVx-1 is net asset value per share

at the end of the previous year, then the portfolio yield is :

$$\frac{(NAV + Dx)}{NAV \times 1} - 1$$

For instance, if NAV × isRs. 110/- Dx is Rs. 15, and NAV × –1 is Rs. 100.

the yield will be: $\frac{110 + 15}{100} - 1 = 25\%$

The so calculated yields of the mutual fund portfolio and unmanaged portfolio are then compared. The one which has the higher yield will be deemed to be the better managed portfolio.

Generally, the average investment returns increase as risk increases. Equities yield more than the bonds as they are riskier. Because of this, mutual funds with portfolios of equities should yield more than portfolios of bonds. Portfolio risk may be measured by the average beta and alpha of the portfolio. The recent trend in the measurement' of mutual fund performance is towards risk adjusted performance.

While measuring the efficiency and reliability of a mutual fund's performance several models were conceived considering both risk and return. In some models characteristic regression lines of the portfolios are estimated with equations.
Dr Michael C. Jensen modified the characteristic regression line to make it useful as one parameter of investment performance measure. The basic random variables in Jensen's model are risk premiums. In Jensen's characteristic line, the **alpha** intercept is a regression estimate of the excess returns from a particular asset. This alpha estimates the excess returns averaged over the sample period used to estimate the characteristic line regression.

Beta is the beta coefficient arid is an index of systematic risk used for ranking the systematic risk of different assets. Beta measures how much the price of a given security is expected to rise and decline in case of rise or decline in the security market. Alpha measures whether the returns on the security are expected to be better or worse than the average security. Whenever portfolio performance is sought to be measured on a risk adjusted basis portfolio beta and alpha values are calculated. Then, a theoretical portfolio having beta and alpha characteristics close to those of the real portfolio is created. The performance of the real portfolio is compared to the theoretical portfolio. Since the risk characteristics of both are same, if the real portfolio returns exceed those of such theoretical portfolio, it can be assumed that the fund had performed well relative to its risk level.

Activity 4

a) For any mutual fund scheme collect the following and study their contents:

Annual Report ....

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Half yearly Report ....

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Balance sheet ....

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Revenue account ....

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b) Consulting the financial newspapers, compile NAV of two open -ended schemes over a period of two years at half monthly intervals and comment on their performance over two years.

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c) Collect application form of any mutual fund scheme and study the contents of *Memorandum containing Key Information'*

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13.9 MAKING MUTUAL FUNDS INVESTOR FRIENDLY

An investor who invests in a mutual fund faces three important types of risks, viz., portfolio risk, organisational risk and management process risk.

The portfolio risk takes place due to inexperience, lack of judgment and far-sightedness of the investment manager. Investors, specially small investors, come to join mutual funds to get benefit of diversification of portfolio. SEBI requires mutual fund to spread the risk by portfolio diversification. For this it has been specified that no mutual fund under all its schemes taken together should invest more than 10 per cent of its funds in the shares or debentures or other securities of a single company and no mutual fund under all its scheme taken together should invest more than 15 per cent of its funds in the shares and debentures of any specific industry, except that a declaration to this effect has been made in the offer letter. For details of restrictions on investments **(*see Annexure 2*)**.

The organisational risk arises due to internal and external reasons associated with the organisation. The prominent among the internal reasons are, frauds committed by employees, theft or misappropriation of investors' funds and uncalled for portfolio manipulation, etc. The organisational risk also arises due to external and uncontrollable factors like a stock market crash sending a shiver down the spines of the investors. Such a situation may render an investment management firm insolvent, making the investors to suffer huge losses. The Securities Exchange Board of India (Mutual Fund) Regulations, 1993 was the first attempt to bring mutual funds under a regulatory framework and to give direction to their functioning. The new guidelines were laid down for authorisation and licensing of mutual funds and each of their schemes. The structure evolved for mutual funds has an attractive feature of arm's length concept to ensure fairness to investors.

The management process risk emanates from errors in the execution of transactions, delays in settlements and losses due to counter party default or speculation. To save investors from speculation, Mutual fund has to take delivery in the case of purchase and give delivery in the case of scrips sold and in no case shall engage in any speculation in the form of short selling, carry forward transactions or badla finance. The scrips purchased shall be transferred to the funds name and scheme also. To lower down the income of schemes AMCs may charge excessive expenses to the scheme. SEBI has laid down the limits for different expense to protect investors against such practices (***See SEBI Regulations***).

When a scheme is launched an *Offer Document* is issued by mutual fund. It provides essential information about the scheme in a way that benefit investors in making decision about subscribing the issue. To ensure that sufficient information is provided in simple language, SEBI has designed a *Standard Offer Document*.

It prescribes the minimum disclosure requirements to be contained in the offer document of any mutual fund scheme. In addition, an abridged offer document i.e. the memorandum containing key information, which must accompany all scheme application forms in terms of sub regulation (4) of regulation 29 of the Regulations, has been standardised. Both these documents have strengthened the disclosure standards in the offer documents fund schemes, thereby enabling the investors to take informed investment decisions. The standard offer document and memorandum mandate the following disclosures :

- submission of the Due Diligence Certificate by the AMC to the SEBI and reproduction of its contents in the offer document.
- standard as well as scheme specific risk factors.
- in the case of assured return schemes, past history of the mutual fund in meeting assurances under such schemes as well as the resources available to the guarantors on the basis of which guarantee is being provided for the new scheme.
- fundamental attributes of the scheme.
- details of the trustees/members of the Board of Directors of the trustee company/AMC as well as a note on the activities of the sponsor and its financial performance for the last three fiscal year.
- transactions with associates undertaken by the mutual fund for the last three years.
- year-wise disclosure of past performance of all schemes launched during the last three fiscal years on the basis of historical per unit statistics including annualised return for all schemes (excluding redeemed schemes).
- all cases of penalties awarded by an financial regulatory body, any pending material litigation proceedings, criminal cases or economic offence cases and any enquiry/adjudication proceedings under the SEBI Act and the regulations made there under, that are in progress against the sponsor or any of its associates including the AMC/Trustee Company/Board of Trustees or any of the directors or key personnel (specifically the fund managers) of the AMC. (For details see SEBI Regulations for Mutual funds *or* visit internet site of SEBI, http:\\www.sebi.gov). Every investor can ask for its copy.

SEBI has, further, laid down Advertisement Code **(*See Annexure 3*)** so that advertisement should be truthful, fair and clear. Target is that investors are not mislead and are protected against false promises.

SEBI has ensured safeguard measures for investors. More and more transparency is desired. Unit Certificates are to be issued to investors with in six weeks from the date of closure of subscription list. SEBI desires that if some units are submitted for transfer, such transfer is to be executed with in 30 days. Dividend warrants against the scheme are to be dispatched with in 42 days of the declaration of the divided. SEBI also desires that with in 10 working days from date of redemption, repurchase proceeds should be dispatched.

If any substantial changes are made in basic features of a scheme, investors are given full liberty by SEBI to exit the scheme. SEBI has laid down several provisions to enable the investors to take informed decisions, in form of pre-launch and post-launch disclosure by a mutual fund. SEBI has a right to call for any information

regarding the operation of the mutual funds, any of the scheme of the mutual fund, asset management company, custodian, sponsor or any other person associated with the mutual fund.

SEBI lays down accounting policies to be complied with by mutual funds and the format and contents of the financial statements and other reports. SEBI can impose monetary penalty of different amounts for different types of violations. The violations that invite penalties include violations of terms and conditions pertaining to registration, compliance of listing conditions, dispatch of unit certificates in the manner provided, refund of application money and investment of money collected under a scheme in the manner or within the period prescribed in the regulations etc. SEBI regularly conducts inspections of mutual funds to ensure that their operating policies are not against the interest of investors. SEBI has been putting ban on defaulting AMC to issue new schemes.

A suitable regulatory structure is the one which is backed by legislative action and supported by industry practices. It is because the legislative regulation, as is prevalent in USA, is likely to instill more public confidence as compared to the self-regulation being practiced in UK. Whatever be the structure of statutory regulation, it is always desirable to supplement it with some kind of self regulatory organization (SRO). Association of Mutual Funds in India (AMFI), mutual fund SRO in India, is doing a great job to evolve investor friendly practices in Indian mutual funds. It is undertaking investor awareness programmes. Mutual funds have to revise their product profile, marketing strategy, investment management systems and disclosure practices. They should design innovative schemes not only for the conventional risk averse types of investors but also for the emerging risk taking type of investors.

Agent-oriented network for marketing also needs a change since agents work only for their commission and have no commitment for mutual fund. In this direction AMFI has taken an appreciable step by designing a professional test which all mutual fund agents are to qualify. The investment strategy which is very conservative and committee type of decision making process also need to be reoriented. The opportunities opened by RBI for mutual funds to invest in markets abroad is to be tried in right perspective.They are to attain maturity to be global players.

13.10 TECHNOLOGY AND MUTUAL FUNDS IN INDIA

Mutual Funds world over are getting to be highly engineering process oriented. Technology is helping mutual funds to contain costs and develop new products using artificial intelligence and expert systems. Customer services are improving day by day with introduction of internet connectivity of mutual funds. All processes are faster and more accurate. Computer simulated training is being imparted to employees of mutual funds. UTI is managing its schemes through its network of 72 locations and registrar offices with a WAN based network using a V-sat hub. It is claimed that UTI has a 1:1 ratio of PCs to employees and has begun selectively using interactive-voice response system too. Mutual fund are striving to exploit fully the potential of electronic media. They are using electronic clearing system to directly crediting bank account of their investor with return on their investment. Funds accounting is totally computerized. Concept of call centres is gaining popularity. Investors sitting at their places can track performance of their investment in mutual fund through internet. AMFI has almost made compulsory to provide specified information about scheme and AMCs of respective mutual funds on AMFI website. SEBI gets proposal for new schemes of mutual funds as a soft copy also which is put on SEBI website for the convenience of investors.

13.11 SUMMARY

The basic purpose of mutual fund is to facilitate the investment process, specially of small investors besides acting as a mobilizing agent. To meet the varied needs of investors, different products/ schemes are offered. At initial stage mutual fund industry took the investors for granted but as investors became disillusioned, mutual funds started mending their ways. Their day-today working is regulated by SEBI regulations which have been revised as and when need was felt to ensure better service and protection to investors. NAV is the basic parameter to comment on efficiency of mutual funds. Primarily mutual funds should strive for better performance as an institutional investor as compared to performance what one average individual can attain. Efforts should be made by them to minimise the operating expenses to maximise the returns. Governance of mutual funds is a continuous challenge for the industry and AMFI.

13.12 KEY WORDS

AMC : An agency which evolve policies for investments and disinvestment of the corpus of schemes of a mutual fund.

Closed End Scheme: A scheme which terminates after a specific period.

Corpus: Total funds with a scheme at any time.

Custodian: An agency for the handling and safekeeping of funds, cash and securities.

Fund: In India fund refers to a mutual fund whereas in U.S.A. fund refers to one scheme. One fund may launch many schemes in India.

Funds Manager: An individual or a group of individuals who make sale and purchase of securities for the schemes of a mutual fund.

Load: It is the charge levied on those who purchase units of a scheme after the initial issue of the scheme. It can be back-end load or front-end load.

Mutual funds: An agency collecting savings. investing them to get better returns and share returns with contributors.

NAV: It is the intrinsic value (not face value) of a unit of a scheme.

Offer Document: It is a document issued giving required details of a mutual fund scheme.

Open End Scheme: A scheme which has no specific time frame for its operation.

Portfolio: A group of securities held together.

13.13 SELF ASSESSMENT QUESTIONS/EXERCISES

1) Discuss the features of different types of schemes which a mutual fund normally launches.
2) SEBI (MF) Regulations ensured diversification of portfolio. Identify the specific provisions for this and their need.
3) ‘SEBI (MF) Regulations have made trustees more responsible’. Discuss.
4) What provisions do you think are there in SEBI regulations to protect the interest of investors.
5) Write a critical note on the growth of mutual funds in India.

6) Explain:

Net Asset Value

Close-ended Scheme

Asset Management Company

13.14 FURTHER READINGS

Bansal Lalit, K., 1996, '*Mutual Funds, Management and Working*', Deep & Deep Publications, New Delhi. .

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Gupta, L.C., 1993, '*Mutual Funds and Assets Preferences*', Society for capital Market Research, New Delhi.

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Annexure 1

INVESTMENT VALUATION NORMS

EIGHTH SCHEDULE Securities and Exchange Board of India (Mutual Funds) Regulations, 1996.

Mutual Fund shall value its investments according to the following valuation norms:

NAV of a scheme as determined by dividing the net assets of the scheme by the number of outstanding units on the valuation date.

1) **Traded Securities**:

i) The securities shall be valued at the last quoted closing price on the stock exchange.

ii) When the securities are traded on more than one recognised stock exchange, the securities shall be valued at the last quoted closing price on the stock exchange where the security is principally traded. It would be left to the asset management company to select the appropriate stock exchange, but the reasons for the selection should be recorded in writing. There should however be no objection for all scrips being valued at the prices quoted on the stock exchange where a majority in value of the investments are principally traded.

iii) Once a stock exchange has been selected for valuation of a particular security, reasons for change of the exchange shall be recorded in writing by the asset management company.

iv) When on a particular valuation day, a security has not been traded on the selected stock exchange, the value at which it is traded on another stock exchange may be used.

v) When a security is not traded on any stock exchange on a particular valuation day, the value at which it was traded on the selected stock exchange or any other stock exchange, as the case may be, on the earliest previous day may be used provided such date is not more than thirty days prior to the valuation date.

2) **'Non-traded Securities'**:

i) When a security is not traded on any stock exchange for a period of thirty days prior to the valuation date, the scrip must be treated as a 'non-traded' scrip.

ii) Non-traded securities shall be valued "in-good faith" by the asset management company on the basis of appropriate valuation methods based on the principles approved by the Board of the asset management company. Such decision of the Board must be documented in the Board minutes and the supporting data in respect of each security so valued must be preserved. The methods used to arrive at values "in-good faith" shall be periodically reviewed by the trustees and reported upon by the auditors as "fair and reasonable" in their report on the annual accounts of the fund. For the purpose of valuation of non-traded securities, the following principles should be adopted:

   a) equity instruments shall generally be valued on the basis of capitalization of earnings solely or in combination with the net asset value. using for the purposes of capitalization, the price or earning ratios of comparable traded securities and with an appropriate discount for lower liquidity;

   b) debt instruments shall generally be valued on a yield to maturity basis, the capitalization factor being determined for comparable traded securities and with an appropriate discount for lower liquidity;

   c) while investments in call money, bills purchased under rediscounting scheme and short-term deposits with banks shall be valued at cost plus

accrual; other money market instruments shall be valued at the yield at which they are currently traded. For this purpose, non-traded instruments, that is, instruments not traded for a period of seven days will be valued at cost plus interest accrued till the beginning of the day plus the difference between the redemption value and the cost spread uniformly over the remaining maturity period of the instruments;

cc) government securities will be valued at yield to maturity based on the prevailing market rate;

d) in respect of convertible debentures and bonds, the non-convertible and convertible components shall be valued separately. The non-convertible component should be valued on the same basis as would be applicable to a debt instrument. The convertible component should be valued on the same basis as would be applicable to an equity instrument. If, after conversion 'the resultant equity instrument would be traded *pari-passu* with an existing instrument which is traded, the value of the latter instrument can be adopted after an appropriate discount for the non-tradability of the instrument during the period preceding the conversion. While valuing such instruments, the fact whether the conversion is optional should also be factored in;

e) in respect of warrants to subscribe for shares attached to instruments, the warrants can be valued at the value of the share which would be obtained on exercise of the warrant as reduced by the amount which would be payable on exercise of the warrant. A discount similar to the discount to be determined in respect of convertible debentures (as referred to in sub-paragraph (d) above) must be deducted to account for the period which must elapse before the warrant can be exercised;

f) where instruments have been bought on 'repo' basis, the instrument must be valued at the resale price after deduction of applicable interest up to date of resale. Where an instrument has been sold on a 'repo' basis, adjustment must be made for the difference between the repurchase price (after deduction of applicable interest up to date of repurchase) and the value of the instrument. If the repurchase price exceeds the value, the depreciation must be provided for and if the repurchase price is lower than the value, credit must be taken for the appreciation.

3) Until they are traded, the value of the "rights" shares should be calculated as:

$$Vr = n/m\ [Pex - Pof]$$

Where

Vr = Value of rights

n = no. of rights offered

m = no. of original shares held

Pex = Ex-rights price

Pof = Rights Offer Price

Where the rights are not treated *pari-passu* with the existing shares, suitable adjustment should be made to the value of rights. Where it is decided not to subscribe for the rights but to renounce them and renunciations are being traded, the rights can be valued at the renunciation value.

4) All expenses and incomes accrued up to the valuation date shall be considered for computation of net asset value. For this purpose, while major expenses like management fees and other periodic expenses should be accrued on a day to

day basis, other minor expenses and income need not be so accrued, provided the non-accrual does not affect the NAV calculations by more than 1 %.

5) Any changes in securities and in the number of units be recorded in the books not later than the first valuation date following the date of transaction. If this is not possible given the frequency of the Net Asset Value disclosure, the recording may be delayed up to a period of seven days following the date of the transaction, provided that as a result of the non recording, the Net Asset Value calculations shall not be affected by more than 1%.

6) In case the Net Asset Value of a scheme differs by more than I %, due to non-recording of the transactions, the investors or scheme/s as the case may be, shall be paid the difference in amount as follows:

   i) If the investors are allotted units at a price higher than Net Asset Value or are given a price lower than Net Asset Value at the time of sale of their units, they shall be paid the difference in amount by the scheme.

   ii) If the investors are charged lower Net Asset Value at the time of purchase of their units or are given higher Net Asset Value at the time of sale of their units, asset management company shall pay the difference in amount to the scheme. The asset management company may recover the difference from the investors.

7.) Thinly traded securities as defined in the guidelines shall be valued in the manner as specified in the guidelines issued by the Board.

8) The aggregate value of illiquid securities as defined in the guidelines shall not exceed 15% of the total assets of the scheme and any illiquid securities held above 15% of the total assets shall be valued in the manner as specified in the guidelines issued by Board.

RESTRICTIONS ON INVESTMENTS

SEVENTH SCHEDULE Securities and Exchange Board of India (Mutual Funds) Regulations, 1996:

1) A mutual fund scheme shall not invest more than 15% of its NAV in debt instruments issued by a single issuer which are rated not below investment grade by a credit rating agency authorised to carry out such activity under the Act. Such investment limit may be extended to 20% of the NA V of the scheme with the prior approval of the Board of Trustees and the Board of asset management company:

Provided that such limit shall not be applicable for investments in government securities and money market instruments:

Provided further that investment within such limit can be made in mortgaged backed securitised debt which are rated not below investment grade by a credit rating agency registered with the Board.

lA) A mutual fund scheme shall not invest more than 10% of its NA V in unrated debt instruments issued by a single issuer and the total investment in such instruments shall not exceed 25% of the NA V of the scheme. All such investments shall be made with the prior approval of the Board of Trustees and the Board of asset management company.

2) No mutual fund under all its schemes should own more than ten per cent of any company's paid up capital carrying voting rights.

3) Transfers of investments from one scheme to another scheme in the same mutual fund shall be allowed only if,

a) such transfers are done at the prevailing market price for quoted instruments on spot basis.

   Explanation.-"Spot basis" shall have same meaning as specified by stock exchange for spot transactions.

b) the securities so transferred shall be in conformity with the investment objective of the scheme to which such transfer has been made.

4) A scheme may invest in another scheme under the same asset management company or any other mutual fund without charging any fees, provided that aggregate inter scheme investment made by all schemes under the same management or in schemes under the management of any other asset management company shall not exceed 5% of the net asset value of the mutual fund.

5) The initial issue expenses in respect of any scheme may not exceed six per cent of the funds raised under that scheme.

6) Every mutual fund shall buy and sell securities on the basis of deliveries and shall in all cases of purchases, take delivery of relative securities and in all cases of sale, deliver the securities and shall in no case put itself in a position whereby it has to make short sale or carry forward transaction or engage in badla finance.

Provided that mutual funds shall enter into derivatives transactions in a recognised stock exchange for the purpose of hedging and portfolio balancing, in accordance with the guidelines issued by the Board.

7) Every mutual fund shall, get the securities purchased or transferred in the name of the mutual fund on account of the concerned scheme, wherever investments are intended to be of long-term nature.

8) Pending deployment of funds of a scheme in securities in terms of investment objectives of the scheme a mutual fund can invest the funds of the scheme in short-term deposits of scheduled commercial banks.

9) No mutual fund scheme shall make any investment in:

a) any unlisted security of an associate or group company of the sponsor; or
b) any security issued by way of private placement by an associate or group company of the sponsor; or
c) the listed securities of group companies of the sponsor which is in excess of 25% of the net assets. .

10) No mutual fund scheme shall invest more than 10 per cent of its NAV in the equity shares or equity related instruments of any company:

Provided that, the limit of 10 per cent shall not be applicable for investments in 6[case of] index fund or sector or industry specific scheme.

11) A mutual fund scheme shall not invest more than 5% of its NAV in the unlisted equity shares or equity related instruments in case of open ended scheme and 10% of its NAV in case of close ended scheme.

ADVERTISEMENT CODE

SIXTH SCHEDULE Securities and Exchange Board of India (Mutual Funds) Regulations, 1996

1) An advertisement shall be truthful, fair and clear and shall not contain a statement promise or forecast which is untrue or misleading.

2 An advertisement shall be considered to be misleading if it contains

a) Misleading Statements:-Representations made about the performance or activities of the mutual fund in the absence of necessary explanatory or qualifying statements, and which may give an exaggerated picture of the performance or activities, than what it really is.

b) An inaccurate portrayal of a past performance or its portrayal in a manner which implies that past gains or income will be repeated in the future.

c) Statements promising the benefits of owning units or-investing in the schemes of the mutual funds without simultaneous mention of material risks associated with such investments.

3) The advertisement shall not be so designed in content and format or in print as to be likely to be misunderstood, or likely to disguise the significance of any statement. Advertisements shall not contain statements which directly or by implication or by omission may mislead the investor.

4) The sales literature may contain only information, the substance of which is included in the Funds' current advertisements in accordance with this Code.

5) Advertisements shall not be so framed as to exploit the lack of experience or knowledge of the investors. As the investors may not be sophisticated in legal or financial matters, care should be taken that the advertisement is set forth in a clear, concise, and understandable manner. Extensive use of technical or legal terminology or complex language and the inclusion of excessive details which may detract the investors should be avoided.

6) The advertisement shall not contain information, the accuracy of which is to any extent dependent on assumptions. Any advertisement that makes claims about the performance of the fund shall be supported by relevant figures.

7) The advertisement shall not compare one fund with another, implicitly or explicitly, unless the comparison is fair and all information relevant to the comparison is included in the advertisement.

8) The Funds which advertises yield must use standardised computations such as annual dividend on face value, annual yield on the purchase price, and annual compounded rate of return.

9) Mutual funds shall indicate in all advertisements, the names of the Settlor, Trustee, Manager and/or Financial Advisor to the Fund, bringing out clearly their legal status and liability of these entities .

9A) All advertisements containing information regarding performance, advertising yield, return or any scheme detail or inviting subscription to the scheme shall contain disclosures of all the risk factors.

10) All advertisements shall also make a clear statement to the effect that all mutual funds and securities investments are subject to market risks, and there can be no assurance that the fund's objectives will be achieved.

11) If however, in any advertisement a mutual fund guarantees or assures any minimum rate of return or yield to prospective investors, resources to back such a guarantee shall also be indicated.

12) If any existing mutual fund indicates the past performance of the fund in advertisements, the basis for computing the rates of return/yield and adjustments made (if any) must be expressly indicated with a statement that, such information is not necessarily indicative of future results and may not necessarily provide a basis for comparison with other investments. Any- advertisement containing information regarding performance, NAV, yield or returns shall give such data for the past three years, wherever applicable.

13) All advertisements issued by a mutual fund or its sponsor or asset management company, shall state "all investments in mutual funds and securities are subject to market risks and the NAV of the schemes may go up or down depending upon the factors and forces affecting the securities market".

14) All advertisement launched in connection with the scheme should also disclose prominently the risks factors as stated in the offer document along with the following warning statements:

a) is only the name of the scheme and does not in any manner indicate either the quality of the scheme, its future prospectus or returns; and

b) please read the offer document before investing.

14A) Any advertisement reproducing or purporting to reproduce any information contained in a offer document shall reproduce such information in full and disclose all relevant facts and not be restricted to select extracts relating to that item which could be misleading.

14B) No celebrities shall form part of the advertisement.

15) No name can be given to a scheme with a view to subtly indicate any assurance of return, except in the cases of guaranteed return scheme in accordance with regulation 38.

16) No advertisement shall be issued stating that the scheme has been subscribed or oversubscribed during the period the scheme is open for subscription.

17) If a corporate advertisement is issued by the sponsor or any of the companies in the Group, or an associate company of the sponsor during the subscription period, no reference shall be made to the scheme of the mutual fund or mutual fund itself; otherwise it will be treated as an issue advertisement.

18) If a corporate advertisement of a sponsor issued prior to the launch of a scheme makes a reference to the mutual fund sponsored by it or any of its schemes launched/ to be launched, it shall contain a statement to the effect that the performance of the sponsor has no bearing on the expected performance of the mutual fund or any of its schemes.

19) Advertisements on the performance of a mutual fund or its asset management company shall compare the past performances only on the basis of per unit of statistics as per this Regulations. Advertisements for NA V s must indicate the past as well as the latest NA V of a scheme. The yield calculations will be made as provided in these regulations.

CODE OF CONDUCT

FIFTH SCHEDULE Securities and Exchange Board of India (Mutual Funds) Regulations, 1996

1) Mutual fund schemes should not be organised, operated, managed or the portfolio of securities selected, in the interest of sponsors, directors of asset management companies, members of Board of trustees or directors of trustee company, associated persons as in the interest of special class of unit-holders rather than in the interest of all classes of unit-holders of the scheme.

2) Trustees and asset management companies must ensure the dissemination to all unit-holders of adequate, accurate, explicit and timely information fairly presented in a simple language about the investment policies, investment objectives, financial position and general affairs of the scheme.

3) Trustees and asset management companies should avoid excessive concentration of business with braking firms, affiliates and also excessive holding of units in a scheme among a few investors. .

4) Trustees and asset management companies must avoid conflicts of interest in managing the affairs of the schemes and keep the interest of all unit-holders paramount in all matters.

5) Trustees and asset management companies must ensure scheme wise segregation of bank accounts and securities accounts.

6) Trustees and asset management companies shall carry out the business and invest in accordance with the investment objectives stated in the offer documents and take investment decision solely in the interest of unit-holders.

7) Trustees and asset management companies must not use any unethical means to sell; market or induce any investor to buy their schemes.

8) Trustees and the asset management company shall maintain high standards of integrity and fairness in all their dealings and in the conduct of their business.

9) Trustees and the asset management company shall render at all times high standard of service, exercise due diligence, ensure proper care and exercise independent professional judgment.

10) The asset management company shall not make any exaggerated statement, whether oral or written, either about their qualifications or capability to render investment management services or their achievements.

11) (a) The sponsor of the mutual fund, the trustees or the asset management company or any of their employees shall not render, directly or indirectly any investment advice about any security in the publicly accessible media, whether real-time or non-real-time, unless a disclosure of his interest including long or short position in the said security has been made, while rendering such advice.

(b) In case, an employee of the sponsor, the trustees or the asset management company is rendering such advice, he shall also disclose the interest of his dependent family members and the employer including their long or short position in the said security, while rendering such advice.